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RETIREMENT

Auto enrollment in retirement plans can spur savings, but at what cost?
By Rob Burgess
July 15, 2024, 5:56 p.m. EDT

For employees, automatic enrollment in their employer's defined contribution plans can be a great way to start saving for retirement. But, if those savings are offset by debt, they may find themselves worse off than when they started.

Defined contribution plans are a low-cost retirement plan option provided by some employers. In the past, employers offered pension plans or defined benefit plans. However, the cost proved too onerous for many, leading to the shift to defined contribution plans, including 401(k)s and 403(b)s.

In a paper published earlier this month, Jonathan Reuter, a research associate at Boston College, explored defined contribution retirement plan design and participant behavior. His review of the available research found that while the adoption of automatic enrollment has significantly increased participation rates, recent studies have found that the long-run effects on savings are smaller than the short-run effects, with some savings financed through debt.

"You don't want people saving at a modest rate of return and borrowing at a high rate of return," he said in an interview. "That's a bad outcome."

Tom Balcom, founder of 1650 Wealth Managementin Lauderdale-by-the-Sea, Florida, said the success or failure of any plan depends on a variety of factors but most likely comes down to the cash flow needs of the employee. If the employee can't save, they may contribute through the automatic contribution feature, but when they move on to another job or lose their current job, there's a high likelihood that those funds will be used at that time and not rolled into an IRA account or a new 401(k) plan, he said. Income levels play a huge role in saving for goals like college, retirement or a first home.

"When you also add in inflation, it becomes more and more difficult for individuals to save for retirement, let alone save for any unforeseen circumstance," he said. "While I am a big fan of defined contribution plans, each situation is unique, so a one-size-fits-all approach doesn't necessarily make sense."

Once employees are enrolled in these plans, they must then decide how to invest their funds. Employers often face challenges catering to employees who have simple needs compared to others who want more bells and whistles in their investment choices.

Noah Damsky, CFA and founder of Marina Wealth Advisors in Los Angeles, said his firm sometimes helps create plans for employers.

"It's a shame, but I think employers do a bad job of tailoring plans to participants," he said.

Fortunately, said Damsky, there's an easy solution when it comes to investment options, although it's often missed by employers that design these plans: When catering to employees with simple needs, the plan can offer target-date funds and broad-based funds.

"It doesn't need to be more complicated," he said. "This gives those who want a single, target-date fund a simple solution. If they want something somewhat more custom, but still simple, they can invest in these handful of index funds."

For more sophisticated offerings, plans can include a personal choice retirement account (PCRA) option, which allows employees to open brokerage accounts that function like an IRA in terms of open-architecture investment options, said Damsky.

"This combination of simple and sophisticated options is the best solution because it offers everything from straightforward, single-fund target-date options to completely customizable PCRA accounts," he said. "What's most important, is that it leaves options for sophisticated investors without muddying the 401(k) plan with an overwhelming number of options. Keeping the menu of options simple is what's going to keep the everyday employees from fleeing in confusion. We have to make it easy if we want the greatest number of people to participate over the long term."

Nicholas Bunio, CFP at Retirement Wealth Advisors in Downingtown, Pennsylvania, said his clients mostly have 403(b), Thrift Savings Plan (TSP) or 401(k) plans from work, so he always advises them to have a custom investment plan based on what options are available through their employer.

Bunio said he doesn't like target-date or lifestyle fund defaults. These are typically funds of funds, meaning these invest in a mix of underlying funds. The asset allocation is based on a target retirement date, and the closer it gets to that day, the more conservative the fund becomes.

"While anything is better than nothing, the issue is that a client could be taking on more risk than they need or feel comfortable with, or, the opposite, they might be taking on too little risk," he said. "Which can be a bit arbitrary. Also, some target-date funds could be too heavily invested in a more risky asset, such as being invested heavily in the S&P 500, which right now is top heavy in Nvidia."

Andrew Herzog, a wealth advisor at The Watchman Group in Plano, Texas, said almost all of his firm's clients want recommendations regarding allocations.

"However, I would venture to say that the average American just goes with the default option, if any, and most wouldn't consider what 'customization' within a defined contribution plan would mean," he said. "Automatic enrollment helps get people invested, but the investment allocation is just as important, if not more so. After all, contributing to a 401(k) for 30 years that sits in fixed income runs the risk of under-earning, thereby squandering an opportunity to invest in assets that materially outperform inflation."